Common Ownership in America: 1980-2017
By Matthew Backus, Christopher Conlon, and Michael Sinkinson
Executive Summary

Over the past few decades, American households have heeded the wisdom of "buying the market" by investing in index funds, with trillions of dollars flowing into funds run by firms such as Vanguard, BlackRock, and State Street. As a result, these investment management firms became the largest shareholders in most public firms in the United States. Other investors and investment firms have also started to place bets on industries instead of particular firms, a prominent example being Warren Buffett's investment in the U.S. aviation industry, as opposed to a particular firm. As a result, investment portfolios resemble the market portfolio to a greater degree than ever before.

While there is undoubtedly a benefit to households of being able to invest in low-fee index funds, some have raised concerns: If a firm's largest shareholders also hold large stakes in their competitors, might this create an incentive to reduce competition? Might firms internalize the externality that their actions, whether pricing, product design, or market entry, create for competitors? A small paradigm-shift – suppose that firms maximize the portfolio values of their investors, instead of simply own-firm profits – creates incentives to soften competition, a concept referred to as the "common ownership hypothesis.

How big are these incentives, and from what trends do they arise? We explore these incentives by studying common ownership of firms in the S&P 500 index from 1980 to 2017. We document the similarity between investment management portfolios and the market portfolio, showing a marked increase over this time period. We also discuss the theory of the common ownership hypothesis using the idea of "profit weights", terms which emerge from a firm's objective function once one assumes that firms exist to maximize the portfolio values of their investors. These objects have a natural interpretation as the "price" of competitor profits in terms of own profits. One challenge in the study of these incentives is in corporate governance. How does a firm address disagreement between investors who hold different portfolios? We consider a range of assumptions in this regard.

As a baseline, the traditional model of firms has these profit weights equal to zero, while a merger moves them to one among the merging firms. We show that the average profit weights for a pair of firms in the S&P 500 has more than tripled over this time horizon, from 0.2 to nearly 0.7. The implication is that if the common ownership hypothesis were true, the U.S. public economy would be far less competitive than is widely assumed.

As a quantification exercise, consider a simple model of standard differentiated product Bertrand competition. If one were able to activate these common ownership incentives, markups would increase dramatically over the 1980-2017 timeframe, comparable to the level measured in De Loecker and Eeckhout (2018), although not occurring contemporaneously. Interestingly, the profit weights for many firms (up to 10 percent under some assumptions) rise above one, especially in the past few years, raising the concern of "tunneling" of profits from one firm to another, a concern not typically expressed in the context of the U.S. economy.